

UNCLASSIFIED

41
PAGE: 0582

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ENVELOPE

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ZNR UUUUU

HEADER

R 290548Z FEB 92
FM JOINT STAFF WASHINGTON DC
INFO RUEADWD/OCSA WASHINGTON DC
RUEADWD/PTC WASH DC
RUFGAID/USEUCOM AIDES VAIHINGEN GE
RHLBAAA/USCINCSO QUARRY HEIGHTS PM
RHDLCNE/CINCUSNAVEUR LONDON UK//N2/N24//
RHCGSRB/COMUSARCENT FT MCPHERSON GA//AFRD-DSO//
RUWSMXI/MAC INTEL CEN SCOTT AFB IL//IN//
RUCJACC/USCINCCENT MACDILL AFB FL//CARA//
RUCQVAB/USCINCSOC INTEL OPS CEN MACDILL AFB FL
RUSNNOA/USCINCEUR VAIHINGEN GE
RUFTAKA/CDR USAINTELC TRE HEIDELBERG GE
RUEALGX/SAFE

R 290539Z FEB 92
FM AMCONSUL HONG KONG
TO RUEHC/SECSTATE WASHDC 1792
INFO RUEHGP/AMEMBASSY SINGAPORE 8346
RUFHAD/AMEMBASSY ABU DHABI 0123
RUEHJA/AMEMBASSY JAKARTA 0268
RUEHSA/AMEMBASSY PRETORIA 0193
RUFHBG/AMEMBASSY LUXEMBOURG 0035
RUEHIL/AMEMBASSY ISLAMABAD 0096
RUFHLD/AMEMBASSY LONDON 0865
RUEHBJ/AMEMBASSY BEIJING 7700
RUEHIN/AIT TAIPEI 3827
RUESLE/AMCONSUL SHANGHAI 4086
RUEHGZ/AMCONSUL GUANGZHOU 7272
RUEATRS/DEPTTREAS WASHDC
RUCPDC/USDOC WASHDC
RUEHKO/AMEMBASSY TOKYO 9490

BT

CONTROLS

UNCLAS SECTION 01 OF 04 HONG KONG 002609

BEIJING PASS CHENGDU

STATE PASS FEDERAL DEPOSIT INSURANCE CORPORATION

USDOC FOR 4400/REP/EAP/DAS/FLAVIN
4420/REP/OPRCHK/JMATHESON/CLUCYK

DEPTTREAS FOR OASIA/MGOODMAN, OFFICE OF THE COMPTROLLER
OF THE CURRENCY, INTERNATIONAL BANKING DIVISION (L'ENFANT PLAZA)

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DEPARTMENT OF STATE

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UNCLASSIFIED

PAGE:0583

E.O. 12356: N/A

/***** THIS IS A COMBINED MESSAGE *****/

BODY

TAGS: EFIN, HK, UK

SUBJECT: BCCHK LIQUIDATION NO THREAT TO HONG KONG
BANKING

REF: (A) 91 HONG KONG 16744
(B) 91 HONG KONG 15985

1. SUMMARY. THE EMERGENCE OF SOME USD 270 MILLION IN PREVIOUSLY UNRECORDED CLAIMS ON THE HONG KONG BRANCH OF THE BANK OF CREDIT AND COMMERCE (BCCHK) HAS SCUTTLED PLANS TO RESCUE THE BANK AND RESULTED IN A DECISION TO LIQUIDATE. DEPOSITORS MAY RECEIVE UP TO 75 CENTS ON THE DOLLAR IN DUE COURSE INCLUDING A 25 PERCENT PAYOUT LAST YEAR. THE FAILURE REVIVED CALLS FOR A DEPOSIT INSURANCE SCHEME. PROMINENT LOCAL BANKS HAVE CRITICIZED THE PROPOSAL AND IT SEEMS UNLIKELY TO BE ADOPTED. IN CONTRAST, THE IDEA OF A FORMAL "DISCOUNT WINDOW" HAS GAINED WIDER CURRENCY. THE LOCAL BANKING COMMISSION INITIALLY ERRED IN ITS HANDLING OF THE CASE, BUT HONG KONG WAS NOT EXCEPTIONAL IN THIS REGARD. MOST DO NOT ACCEPT THAT THE BCCHK FAILURE CALLS THE EFFICACY OF THE LOCAL REGULATORY STRUCTURE INTO SERIOUS QUESTION. TWO LASTING RESULTS ARE LIKELY TO BE INCREASED REGULATORY SCRUTINY OF FOREIGN BANKING OPERATIONS AND HEIGHTENED DEPOSITOR WARINESS. THE BANK OF CHINA GROUP SEEMS SET TO BENEFIT FROM THE LATTER. END SUMMARY.

BCCHK SALE TORPEDOED BY NEW CLAIMS

0 CHINESE FIRM PULLOUT SIGNALS TROUBLE

2. ALARM BELLS BEGAN RINGING ON FEBRUARY 13TH WHEN PRC STATE ENTERPRISE CHINA RESOURCES REVERSED ITS MID-DECEMBER DECISION TO ACQUIRE A 30 PERCENT SHARE IN INDONESIAN LIPPO GROUP'S PROPOSED PURCHASE OF BCCHK (REFTELS). LESS THAN A WEEK LATER, LIPPO'S HONGKONG CHINESE BANK (HKCB) HAD WITHDRAWN ITS BID.

0 "THE SITUATION HAS NOW CHANGED"

3. THE PROVISIONAL LIQUIDATOR AND HKCB'S EXECUTIVE DIRECTOR BOTH ATTRIBUTED THE BREAKDOWN TO THE EMERGENCE OF MASSIVE UNRECORDED CLAIMS AS OVERSEAS LIQUIDATORS BEGAN SLAPPING LIENS ON THE BANK'S HONG KONG OPERATION. FIRST EMERGING IN MID-DECEMBER BUT PICKING

UNCLASSIFIED

UNCLASSIFIED

PAGE:0584

UP STEAM IN FEBRUARY, SUCH CLAIMS CURRENTLY TOTAL SOME HKD 2.1 BILLION (USD 270 MILLION). ALMOST HALF (HKD 1.01 BILLION OR USD 130 MILLION) REPRESENTS DEALINGS WITH ONE CUSTOMER ALONE, INDONESIA WOOD PRODUCTS CONCERN BARITO PACIFIC, AND INVOLVES TWO DEALS BOOKED VIA TOKYO.

0 OVERSEAS CLAIMS PILE UP

4. OTHER CLAIMS FILED BY BCCI LIQUIDATORS AND THEIR POINTS OF ORIGIN INCLUDE: LUXEMBOURG FOR HKD 125 MILLION (USD 16 MILLION); LONDON FOR HKD 85 MILLION (USD 11 MILLION); SAN FRANCISCO FOR HKD 570 MILLION (USD 73 MILLION); NEW YORK FOR HKD 31 MILLION (USD 4 MILLION); AND BCCI CAYMAN ISLANDS FOR HKD 275 MILLION (USD 35 MILLION). AGAINST THESE WAS SET THE ABU DHABI GOVERNMENT'S WILLINGNESS TO GUARANTEE ONLY USD 25 MILLION IN UNRECORDED LIABILITIES, LESS THAN A TENTH OF THE CLAIMS ACCUMULATED THUS FAR.

0 DEPOSITORS TO RECEIVE UP TO '5 CENTS ON DOLLAR

5. WHILE SOME OF THE CLAIMS MIGHT WELL HAVE BEEN DISMISSED, IT WAS FEARED THAT OTHERS WOULD ARISE IN THEIR PLACE AND THE DECISION WAS TAKEN TO PROCEED WITH LIQUIDATION. BCCHK DEPOSITORS MAY EVENTUALLY RECEIVE

/***** BEGINNING OF SECTION 002 *****/
AS MUCH AS 75 PERCENT OF THEIR FUNDS, INCLUDING 25 PERCENT PAID LAST YEAR. THIS COMPARES FAVORABLY WITH THE 85 PERCENT PAYOUT PROMISED BY LIPPO, BUT THE PROCESS COULD TAKE A GOOD DEAL LONGER. EVEN SO, LOCAL DEPOSITORS ARE REPORTEDLY RELATIVELY BETTER OFF THAN MANY BCCI CUSTOMERS ELSEWHERE AS BCCHK WAS "CASH RICH" AT THE TIME OF ITS DEMISE. FUNDS TOTALING HKD 4 BILLION (USD 500 MILLION) ARE CURRENTLY ON DEPOSIT WITH LOCAL BANKS.

FAILURE LEADS TO CALLS FOR DEPOSIT INSURANCE

0 TWO PRINCIPAL FUNCTIONS

6. BCCHK'S FAILURE SHOOK LOCAL DEPOSITOR CONFIDENCE AND LED TO RENEWED CALLS FOR DEPOSIT INSURANCE (THE IDEA WAS LAST BROACHED IN 1985). AFTER A PERIOD OF STUDY, THE HONG KONG GOVERNMENT (HKG) RECENTLY RELEASED A CONSULTATIVE PAPER ON THE SUBJECT AND INVITED PUBLIC COMMENT. ACCORDING TO THE DOCUMENT, THE TWO PRINCIPAL AIMS OF SUCH A SCHEME ARE TO PROTECT SMALL DEPOSITORS AGAINST THE NON-SYSTEMIC FAILURE OF ANY BUT THE LARGEST

UNCLASSIFIED

UNCLASSIFIED

PAGE: 0585

BANKS AND TO RAISE THE PUBLIC'S "CRISIS OF CONFIDENCE THRESHOLD" SO AS TO ENHANCE BANKING SYSTEM STABILITY.
0 CAVEATS

7. NONETHELESS, THE PAPER WARNED THAT DEPOSIT INSURANCE CANNOT PREVENT BANK FAILURES NOR CAN IT ADDRESS SYSTEMIC PROBLEMS. INDEED, IT MAY NOT EVEN PREVENT RUNS ON OTHERWISE HEALTHY BANKS SINCE COMPENSATION FROM THE INSURANCE AUTHORITY WILL TAKE TIME AND PANICKY DEPOSITORS MAY NOT WISH TO CHANCE BEING FORCED TO WAIT FOR THEIR FUNDS.

0 NOT FOR LIQUIDITY SUPPORT

8. THE HKG IS ALREADY PREPARED TO PROVIDE LIQUIDITY SUPPORT TO SOLVENT BANKS ON A COMMERCIAL BASIS VIA THE EXCHANGE FUND, BUT THE PAPER ARGUES THAT DEPOSIT INSURANCE SHOULD NOT BE REGARDED AS A MEANS OF PROVIDING SUCH LIQUIDITY. EVEN SO, IT APPEARS THAT THE TERRITORY MAY BE HEADED FOR SOME SORT OF "DISCOUNT WINDOW" WHEREIN EXISTING ARRANGEMENTS WOULD BE FORMALIZED AND BANKS ALLOWED TO OFFER LONG-TERM SECURITIES AS COLLATERAL WHEN SEEKING SHORT-TERM ASSISTANCE. PROMINENT BANKER AND BANKING CONSTITUENCY LEGISLATIVE COUNCILLOR DAVID LI LENT PUBLIC SUPPORT TO SUCH A COURSE RECENTLY, SAYING THAT THE MEASURE WOULD HELP ENGENDER GREATER CONFIDENCE IN THE BANKING SYSTEM.

9. LI NOTED THAT BANKERS AND DEPOSITORS WERE SHOCKED BY THE HKG'S REFUSAL TO USE EXCHANGE FUND ASSETS (WHICH BACK THE LOCAL CURRENCY) TO RESCUE BCCHK. INDEED, THIS IS THE FIRST POSTWAR INSTANCE OF THE GOVERNMENT'S REFUSAL TO RESCUE A FAILED BANK OR TO FIND A "WHITE KNIGHT" TO DO THE JOB. ADMITTEDLY, HOWEVER, PREVIOUS RESCUES HAD ALL BEEN OF LOCAL BANKS. FURTHERMORE, THE GOVERNMENT MAINTAINS THAT THE EXCHANGE VALUE OF THE HONG KONG DOLLAR HAD NOT BEEN THREATENED BY THE BCCHK COLLAPSE SO THE EXCHANGE FUND STATUTE (ENABLING LEGISLATION DATING FROM THE PREWAR PERIOD) PREVENTED FUND ASSETS FROM BEING USED IN THE BANK'S DEFENSE.

0 MORAL HAZARD PROBLEM

10. OVERLY GENEROUS DEPOSIT INSURANCE ALSO RAISES THE "MORAL HAZARD" PROBLEM IN THAT HIGH RISK/HIGH REWARD

/***** BEGINNING OF SECTION 003 *****/
DEPOSITORS AND IMPRUDENT BANK MANAGERS MAY CHOOSE TO EXPLOIT THE PROTECTION OFFERED. THE CONSULTATIVE PAPER REFERS EXPLICITLY TO THE U.S. CASE AND IDENTIFIES MORAL HAZARD AS A CONTRIBUTORY FACTOR TO THE PROBLEMS

UNCLASSIFIED

UNCLASSIFIED

PAGE:0586

CURRENTLY BEING FACED BY U.S. DEPOSIT INSURANCE
AUTHORITIES.

0 UNEQUAL BURDEN ON DEPOSITORS

11. FINALLY, DUE TO THE SKEWED DISTRIBUTION OF LOCAL DEPOSITS (HONGKONG/HANG SENG BANKS AND THE BANK OF CHINA GROUP ACCOUNT FOR MORE THAN HALF OF ALL DEPOSITS), A LARGE PROPORTION OF THE COSTS OF THE SCHEME WOULD BE BORNE BY THE MOST DEPOSITORS AT THE LARGEST BANKS IN THE SYSTEM - PRECISELY THOSE INSTITUTIONS WHOSE LEAST LIKELY TO FAIL AND TOO BIG FOR EFFECTIVE PROTECTION IN ANY CASE.

NEGATIVE REACTIONS PREDOMINATE

12. IN THE EVENT, BOTH HONGKONG BANK AND ITS 61 PERCENT OWNED SUBSIDIARY HANG SENG BANK HAVE COME OUT PUBLICLY AGAINST THE SCHEME. WHILE THE BANK OF CHINA GROUP (13 "SISTER" BANKS WHOLLY OR PARTLY OWNED BY CHINA) HAS YET TO STATE ITS STANCE, TOP BOC OFFICERS HAVE IN THE PAST POINTED OUT TO CONGENOFFS THAT DEPOSIT INSURANCE SYSTEMS IN OTHER LOCATIONS, PARTICULARLY THE UNITED STATES, HAVE NOT BEEN PARTICULARLY SUCCESSFUL. OTHER BANKERS HAVE EXPRESSED SIMILAR VIEWS IN PRIVATE AND PUBLIC. COMMENT. WE SUSPECT THAT THIS IS AN IDEA WHOSE TIME HAS NOT YET COME IN HONG KONG AND THAT IT WILL BE PUT AWAY ONCE AGAIN FOLLOWING THE PUBLIC COMMENT PERIOD WHICH ENDS MAY 31. END COMMENT.

LONG-RUN IMPLICATIONS

13. BASED ON CONVERSATIONS WITH LOCAL AND FOREIGN BANKERS AND ANALYSTS BASED HERE, CONGEN CONCLUDES THAT THE LONG-RUN IMPLICATIONS OF THE BCCHK CASE FOR HONG KONG'S BANKING SYSTEM ARE TWO. FIRST IS INCREASED WARINESS OF FOREIGN BANKING OPERATIONS AND SECOND IS CHANGED DEPOSITOR EXPECTATIONS.

0 HEIGHTENED WARINESS OF FOREIGN BANKS

14. THE LOCAL BANKING AUTHORITIES CAME UNDER WIDESPREAD AND AT TIMES BITTER CRITICISM OVER THEIR INITIAL MISSTEPS IN HANDLING THE AFFAIR. THE BANKING COMMISSIONER AT FIRST ALLOWED BCCHK TO REMAIN OPEN EVEN AFTER THE BANK OF ENGLAND HAD CLOSED DOWN BCCI OPERATIONS IN THE UNITED KINGDOM. HE THEN MADE MATTERS WORSE BY STATING THAT THE BANK'S LOCAL OPERATIONS REMAINED "SOUND AND VIABLE."

UNCLASSIFIED

15. COMMENT. IN FACT, SUBSEQUENT DEVELOPMENTS HAVE DEMONSTRATED THAT EARLIER EFFORTS BY THE HONG KONG BANKING COMMISSION TO INSULATE THE LOCAL OPERATION FROM OVERSEAS BCCI OPERATIONS HAD BEEN FAIRLY SUCCESSFUL. NONETHELESS, THEY ALSO BEAR ELOQUENT WITNESS TO BCCHK'S VULNERABILITY TO DAMAGE FROM BCCI'S TUMBLING HOUSE OF CARDS. END COMMENT.

0 POSSIBLE DOWNGRADING DISCOUNTED

16. DESPITE THE BLOW TO GOVERNMENT PRESTIGE DEALT BY THE EVENTS OF LAST JULY/AUGUST, MOST BANKERS CONCEDE THAT THE LOCAL REGULATORY AUTHORITIES COULD NOT HAVE

/***** BEGINNING OF SECTION 004 *****/
PREVENTED BCCHK'S COLLAPSE IN ANY EVENT AND DISMISS ALLEGATIONS THAT THE LOCAL BANKING REGULATORY STRUCTURE ITSELF IS IN DISREPAIR. INDEED, A HIGHLY RESPECTED U.S. BANKER HERE REACTED UNPRINTABLY TO A REPORT THAT REGIONAL RATING FIRM CAPITAL INFORMATION SERVICES PLANNED TO DOWNGRADE THE BANK REGULATION SECTION OF ITS RATING SCHEME WITH RESPECT TO HONG KONG.

0 TIGHTER SCRUTINY (WITHIN LIMITS)

17. THE LOCAL AUTHORITIES HAVE MADE IT CLEAR THAT IN FUTURE THE LOCAL OPERATIONS OF FOREIGN BANKING PARENTS WILL BE UNDER CLOSER SCRUTINY. COMMENT. THEY ARE NOT ALONE IN THIS NEWLY FOUND CAUTION. END COMMENT. BANKING COMMISSIONER DAVID CARSE SOUNDED A CAUTIONARY NOTE TO A PROFESSIONAL AUDIENCE, HOWEVER, WHEN HE NOTED THAT ENTIRELY PREVENTING ANOTHER SITUATION SUCH AS BCCHK WOULD CALL FOR A MUCH TOUGHER AND INTRUSIVE REGULATORY REGIME.

0 CHANGED DEPOSITOR EXPECTATIONS

18. AS DISCUSSED ABOVE, LOCAL DEPOSITORS HAD COME TO EXPECT THAT THE HONG KONG GOVERNMENT WOULD ULTIMATELY STEP IN TO RESCUE FAILING BANKS. WHEN IT BECAME CLEAR THAT THIS WAS NOT TO BE IN BCCHK'S CASE, ENSUING PANIC LED TO RUNS ON THREE ARAB-AFFILIATED INSTITUTIONS AND ULTIMATELY TO NONSENSICAL MASS WITHDRAWALS FROM CITIBANK AND STANDARD CHARTERED BANK (ONE OF THE TERRITORY'S TWO BANKS OF ISSUE).

19. IN THE WAKE OF THESE EVENTS, WE HAVE ALREADY SEEN INCREASES IN RETAIL DEPOSITS AT LOCAL LEADERS HONGKONG BANK, HANG SENG BANK, THE BANK OF CHINA, AND THE BANK OF EAST ASIA AT THE EXPENSE OF SMALLER INSTITUTIONS. AS A RESULT, HONG KONG'S SKEWED DEPOSIT DISTRIBUTION IS

UNCLASSIFIED

PAGE:0588

BECOMING EVEN MORE SO AS DEPOSITORS HAVE COME TO
REALIZE THAT GOVERNMENT INTERVENTION IS NOT ASSURED.

COMMENT: ILL WIND BLOWS GOOD TO BANK OF CHINA

20. COMMENT. WITH THE EXCEPTIONS OF HEIGHTENED
REGULATORY WARINESS AND MORE CONSERVATIVE DEPOSITOR
BEHAVIOR, WE DOUBT THAT THE LOCAL BANKING SYSTEM WILL
SUFFER ANY APPRECIABLE LONG-TERM NEGATIVE EFFECTS FROM
THE BCCHK CASE, PARTICULARLY AS HONG KONG WAS JUST ONE
OF A NUMBER OF JURISDICTIONS VICTIMIZED BY BCCI'S
GLOBAL ANTICS. THE AFTERMATH OF THE INCIDENT WILL,
HOWEVER, ADD IMPETUS TO THE CONCENTRATION OF RETAIL
BANKING ACTIVITY - AN OUTCOME WHICH CONTRIBUTES TO THE
CONTINUING RISE OF THE BANK OF CHINA GROUP HERE. END
COMMENT.

WILLIAMS

ADMIN

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